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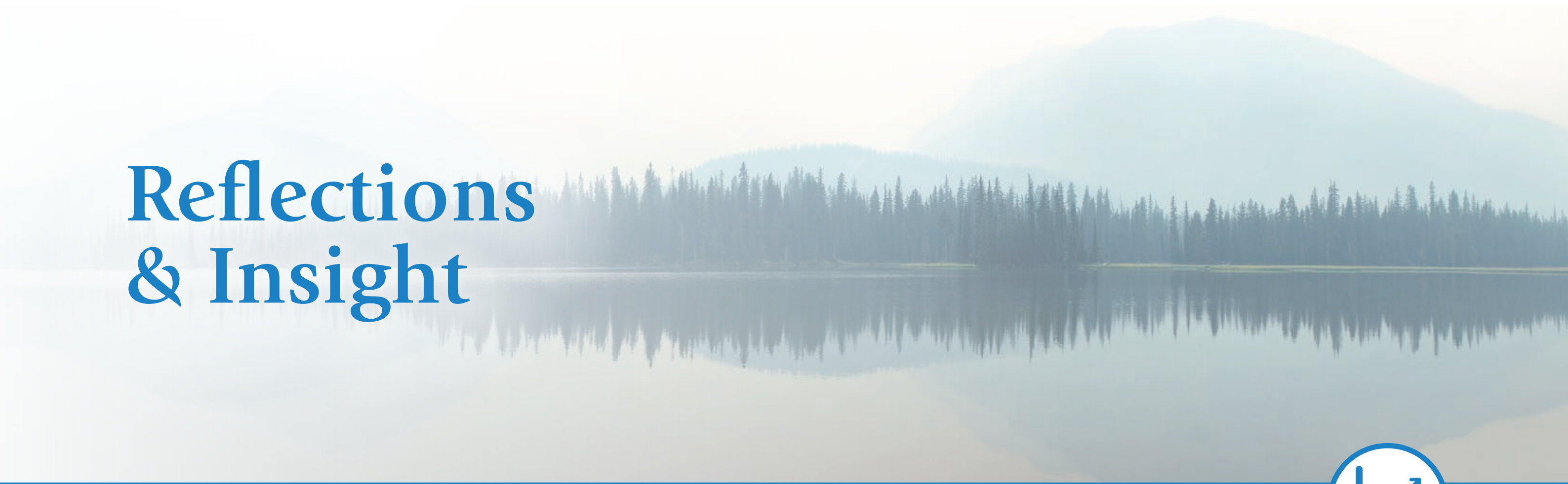
Reflections & Insight



QUARTER TWO 2020

> “Another plague year would reconcile all these differences; a close conversing with death, or with diseases that threaten death, would scum off the gall from our tempers, remove the animosities among us, and bring us to see with differing eyes than those which we looked on things with before.” *Daniel Defoe, A Journal of the Plague Year*

The metamorphosis of the pundit from trade specialist to virologist is in full swing. Today’s situation was unimaginable three months ago, and it is astonishing both how quickly the world has changed and how quickly the world has adapted to the new circumstances.

Trying to estimate the effects of the COVID-19 crisis feels like a counsel of despair. The reality is that nobody knows how things will unfold, although some prognosticators will no doubt be right on the same principle as the stopped clock being accurate twice a day. This review will attempt instead to look at some of the factors that we think are discernible in the mist.

The first of these is to do with the policy response, both monetarily and fiscally. Across the world, monetary policy is on a spectacularly easy setting. Central banks everywhere are supplying liquidity to any market which looks as if it needs it. This is the way they intend to avoid the mistakes of the Great Financial Crisis, whereby the contagion from the financial world spread into the economy and produced the 2008/9 recession. Fiscally, we see enormous programmes to support workers and businesses, struggling with the abrupt cessation of activity. In these reviews in the past, there had been speculation about what would happen in the next recession, whenever it came, in a world of very low interest rates. Now we know. Governments around the world have stepped up to the plate to a greater or lesser extent to protect people and businesses and to prevent the wholesale destruction of human and physical capital.

These programmes are on a scale never before seen – and the need is unarguable. In the last two weeks alone, for example, 10 million Americans have lost their jobs. It would be morally irresponsible for nation-states to abandon their people in such a crisis, and they are indeed trying not to. The difficulty is in making sure that resources quickly reach those in most need. There is all manner of special corporate pleading to get to the front of the queue. Still, it is at the individual level that the need is greatest, both on humanitarian grounds and to ensure social cohesion in the midst of a repressive lockdown in most countries. There will be massive inefficiencies in distribution because the systems required to pull this off do not exist. For this reason, a combination of banks, employers, state organs and specialist organisations are acting as distribution vectors, and the behaviour of these will not always be ideal. There will be credit providers who require personal guarantees for loans when policy dictates these are not necessary; unjustified fees will be charged, and some will attempt to profiteer. Nevertheless, the requirement to shift this assistance to huge numbers of individuals will tolerate some 'externalities' or things which in normal times would look dreadful.

Monetary and fiscal policy is, therefore, on a setting that can be summed up as offering 'whatever it takes' to stop the global economy grinding to a complete stop and hobbling its ability to recover when the COVID-19 crisis recedes.

These policies have been enough to stabilise markets for now, although it would be rash to assume that volatility will not return as the course of the pandemic develops. In the initial market sell-off, which has become known as a 'waterfall' decline, everything fell. An encouraging sign (albeit not really a green shoot) is that there is now differentiation between stocks and markets which may have resilience in the face of the crisis, and those which do not. The problem for investors is that the contours of a post-COVID-19 world are very indistinct. What is probably true, although this can only be a tentative view, is that markets are discounting a catastrophic economic collapse in the second quarter of this year – perhaps as much as a 25% decline at an annual rate, followed by a smaller decline in the third quarter, and then some stabilisation and modest growth towards the end of the year. Corporate profits are obviously in real trouble, and dividends are likely to be cut across the board. Stock and bond markets know all this. What they don't know is how long this period of lockdown will last, and what the recovery will look like. Pundits like to talk about 'V' shaped recoveries, or 'U' shaped ones, and pessimists have 'L' shapes to groan about. Who knows?

Despite this, it seems rational to suppose that monetary and fiscal policy will remain on the current settings well into whatever recovery unfolds, partly because of the risk of triggering a secondary economic collapse and partly because of the risk of a second wave of COVID-19. It feels faintly unsavoury to make this point, but this would be an environment that is very positive for equity markets, particularly in nominal terms.

China was first into the tank and is first to come out. The authorities there have employed both fiscal and monetary levers to stabilize things, and productive capacity is gradually returning to normal. The severity of the lockdown has probably shortened the time frame over which this is happening, but things are still some way from feeling normal. There is real concern about a second wave of infection brought by returnees, social distancing is being practiced widely, and those who can work from home are still doing so for parts of the week. This is all happening when the demand for Chinese goods has fallen through the floor, so the recovery there will largely be on the back of domestic demand. High-frequency data suggest that growth in the second quarter will resume, albeit at a lower rate than seen in the recent past. This gives us a model of what might happen, although the fiscal and monetary stimulus in the EU and US is much bigger, pointing to the potential for a more vigorous bounce.

In the meantime, companies are in survival mode: investment has been stopped, balance sheets are being bolstered where possible, and cash is king. Turning this mentality around will require a resurgence of confidence that COVID-19 has left the building. It is natural that all of us focus on those nearest to us. Still, a pandemic does not respect barriers, and the consequences of the inability of health care systems in Africa and other developing countries to deal with the virus will hang over the world until the development of a vaccine, or an understanding that immunity has become embedded in some other way, provides an exit.

Given all this, another thing which may change in due course is inflation. For now, we are in a profoundly deflationary environment where demand has plummeted, and monetary velocity (which measures how quickly money is circulating) has crashed. This has serious implications for those with debt and explains why debt forgiveness is a key part of the fiscal impulse around the world. In the longer term, though, the measures to stimulate demand and build consumer confidence will most likely lead to more inflationary times. It is too soon to be confident about this view. Indeed, in Japan, the last decade of fiscal expansion has failed to ignite inflation. Nevertheless, circumstances there are different from those which are likely to prevail in a post-crisis world, and it is possible that the benign inflationary environment which has driven a forty-year bond bull market may enter its twilight years. It does however; seem likely that the value of fiat money may change relative to real assets. This would be an environment that may be beneficial for gold or other real assets.

One implication of all this is that large holdings of cash in portfolios may be riskier in real terms than it may feel, particularly as monetary policy is likely to remain very loose.

It is worth remembering that at the end of this, the globe will be absolutely awash in debt. There are three ways this can be addressed: growth in real terms would allow repayment, or: it can go into default, or it can be inflated away. There are no prizes for guessing which route policymakers would prefer (with the possible exception of Germany).

The political implications of the crisis are also hard to discern. The impact of current policies is akin to the nationalisation of large swathes of the economy. The state (writ large) will justifiably demand some return for its rescue packages but will also want to exit from its unnatural asset holdings. In badly affected industries, equity holders may well be wiped out. Individuals will most likely have to bear a higher tax burden – in the short term, to redress some of the economic imbalance and in the longer term to build some resilience into governmental structures like health care. Whether politics draws the conclusion that greater co-operation between nations is needed or that it is every person for themselves is anybody's guess. Given the fault lines in the EU and the US, there is a risk that the latter path dominates, which would be bad news for investors.

These reviews generally try to give a balanced view of the risks and opportunities for investors. This time, uncertainty is the watchword, although some of the post-COVID-19 world is faintly visible. Looking at the longer term, it seems likely that the opportunities for investors will have changed. A few examples:

- The trend towards the digitisation of the global economy has been given a further shot in the arm. This will benefit many providers of technology – (who knew how to use Zoom before the lockdown?) Bricks and mortar retailers will come under further pressure;
- The capacity to work remotely, while theoretically possible, has turned out for most office workers to be fairly straightforward. This could have implications for office space in major centres and also for business travel;
- Supply chains have been shown to lack resilience – excessive dependence on outsourcing and manufacturing offshore will likely lead to a diversification of supply chains, helped by the development of automated manufacturing technologies (e.g. 3D printing);
- Health care systems will be examined for resilience and the need to build in some redundancy, and the costs of healthcare are likely to rise. New drug discovery is likely to get a boost, and co-operation between academia and commerce should increase;
- Companies will be rewarded for financial strength and some inefficiencies in balance sheet management, and inventory control will become normal. The era of the pursuit of efficiency over everything else is finished;
- The multi-decade long trend towards globalisation will change in unexpected ways;
- Trends and patterns of consumption may be altered permanently;
- The climate change agenda may be accelerated with consequences for the long-term sources and pricing of energy.

In sum, portfolios need to use the current instability to pursue quality over any other attribute. Quality is characterised by the strength of the balance sheet, the resilience and diversification of the product line alongside a focus on the new economy, the ability to deliver growth in difficult times, and the ability to generate cash. These are the factors that will most likely be rewarded by markets in a chastened global arena.